Memorandum

To: Arm’s-Length Adjustment Service Advisory Group

From: Dan Bucks, Project Facilitator

Date: July 21, 2014

Re: Maximizing Cost-Benefit of Economics Expertise: Item III.A for July 28 Meeting

This memorandum identifies possible approaches to maximizing the cost-benefit of economics expertise by minimizing costs and applying the expertise in the most effective ways. The first three ideas are suggestions for discussion. These ideas are not exhaustive, and the advisory group may well develop other approaches related to the objective of cost-effective economic analysis.

The fourth item listed—interstate cooperation and consultation on transfer pricing studies—has been assumed from the outset as an inherent feature of the project. It is included here because of its relationship to the overall topic of this memorandum and to help the advisory group to refine its details.

Some potential strategies include:

1. Securing background information necessary to analyzing taxpayer transfer pricing studies.

Some vendors report that if the data and information on which transfer pricing studies are based is not obtained in the course of an audit, they cannot effectively analyze those studies to determine their validity. Accordingly, auditors need to request that source information as early as possible in the audit process. States need to be prepared to enforce those requests if the information is not forthcoming.

Potential project activities to support these efforts might include:

• Developing common information request protocols among project states.

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• Training state and MTC audit and legal staff on information document request procedures with regard to transfer pricing studies.
• Advising state and MTC staff on tailoring document requests to fit particular taxpayer situations.
• Providing legal advice or support for enforcing document requests.

2. Training state and/or MTC staff to conduct technical, first level reviews of transfer pricing studies prior to advanced reviews by economists.

Some transfer pricing experts report that it is possible for technical staff to review transfer pricing studies to identify technical deficiencies prior to an economic analysis. Technical staff could identify a failure of such studies to follow federally recognized standards, inconsistencies in the selection of comparables and other technical errors. These technical reviews could save costs by allowing more expensive economics expertise to be focused on advanced economics and statistical analysis instead of on these technical problems.

Project activities that might support these efforts include:

• Training state staff to conduct technical reviews.
• Developing central project staff to conduct technical reviews at the request states for their separate state audits and for any joint MTC audits.

3. Employing one or more economists within the MTC project staff to conduct transfer pricing analysis and related support and advice to states.

The MTC might develop over time economics expertise as a part of the project staff to work in conjunction with contracted expertise. Such staffing at the outset could be an experienced PhD economist with a transfer pricing background to conduct economic and statistical reviews of taxpayer transfer pricing studies. Over time, the staff could employ and train newer PhD economists and move beyond reviewing taxpayer studies to developing alternative transfer pricing studies for states. The economists could also assist with the various training efforts with regard to state audit and legal staff on integrating economics analysis into transfer pricing administration.

In essence, while in the early years the MTC project might rely significantly on contracted economics expertise, much of the work and expertise could be transferred progressively in-house as the project matures. There is likely a long-term role for contracted expertise to assist with advanced issues and fluctuating volumes of analytical work. Nonetheless, considerable expertise could be developed on staff at a reduced cost to states.
4. Interstate cooperation and consultation on transfer pricing studies.

The Arm’s Length Adjustment Service Project began with the assumption that there would be some level of cooperation among states on transfer pricing studies. One thought is that as a state encounters a taxpayer’s transfer pricing study, it would notify other project states of that study and request assistance with it. Staff for the MTC project could then follow-up and organize joint work among states expressing interest in the analysis of the same study. That work might include:

- Convening interstate discussions of the case,
- Sharing information on prior analyses of that study, and
- If sufficient interest exists, organizing technical and economic reviews of the study for the interested states.

The latter task would involve identifying the mix of state and project staff and contracted resources to accomplish the review. How the appropriate reviews would be conducted would depend upon the resources available through the project—decisions about which have not yet been fully made.

Cost-sharing arrangements need to be developed within the project. If all states are interested in the analysis of a taxpayer transfer pricing study, then any variable costs—such as contracted services—would presumably be spread among all states. Whether the costs are (a) shared equally or (b) by a formula, for example, with part shared equally and another part shared proportionately to the relative corporate tax revenues of each state or (c) by some other method is a matter the advisory group may wish to discuss.

Another consideration might be what to do in the instance where only some of the project states initially participate in analyzing a case, but another project state or states subsequently use the analysis. Would the states using the analysis later pay a share of the costs of that analysis? Would the funds from the “late cost-sharing” go into a fund to finance credits to be used by the initial states to help finance future analyses or other project fees such as registration costs for project training courses?

Maximizing the cost-benefit of any technical and economic analysis of a transfer pricing study obviously involves ensuring that such analyses be shared among all the states in the project. Accomplishing the sharing of valuable information, in practice, means that the states need to agree upon equitable cost-sharing methods.

Also implicit in the sharing of transfer pricing study information is the availability of an information exchange framework among project states.